PRA Dear CFO Letter – IFRS 9 ECL

What does it mean for you?

October 2024

The dynamic landscape of regulation and risk management presents ongoing challenges for banks and building societies. A key area of focus within this landscape is the IFRS 9 Expected Credit Loss (ECL) framework.

Enhancing IFRS 9 ECL Practices in the Banking Sector

On 27 September 2024, the PRA published a Dear CFO letter, providing thematic feedback on the ECL framework under IFRS 9 and accounting for climate risks.

Our insights paper delves into the thematic findings related to IFRS 9 to provide a focused perspective on what these findings mean for you.

A key message in the PRA's letter is that model risk remains elevated, requiring rigorous evaluation of post model adjustments (PMAs) to ensure provisions reflect actual expectations of credit losses, especially with higher interest rates.

The PRA also noted that firms have made good progress in updating models and reducing reliance on aged models with known limitations, but firms should continue to enhance model redevelopment plans to align with SS 1/23.

The PRA also highlighted that the areas of focus and high-quality practices outlined in this letter have been tailored to suit the size, nature, and complexity of firms that fall under the scope of written auditor reporting. **However, these insights and recommendations are also valuable for other firms applying IFRS 9, even if they are not subject to the same reporting requirements.**

By adopting the best practices and addressing the challenges highlighted by the PRA, firms can improve their risk management capabilities and ensure compliance with regulatory expectations.

Key Takeaways:

- ECL should reflect the impact of rising interest rates on affordability and refinance risks
- Regularly update and monitor models to reduce reliance on outdated ones
- Challenge and validate recovery assumptions to ensure they are realistic, especially with new recovery strategies or complex recovery paths
- Expand risk frameworks to include lower credit quality corporate assets, using reasonable and supportable information for long-term assessments
- Identify and manage vulnerable borrower segments, ensuring key risks are captured in ECL calculations

Thematic Findings on IFRS 9 ECL (1/3)

Areas of Focus	Near Term Focus	Medium Term Focus
1 **Model Risk and PMAs**	**Completeness of PMAs:** Ensure provisions accurately reflect expected credit losses. Firms must rigorously assess PMAs, especially with higher interest rates affecting affordability and refinance risk. This involves moving away from approximate approaches and ensuring PMAs are calculated at a granular level. **Model Redevelopment:** Updating models and reducing reliance on outdated ones is crucial. Firms should monitor redevelopment plans to enhance capabilities and align with supervisory statements such as SS1/23. Develop robust testing environments and address all model limitations.	**Enhancing Model Monitoring and Validation:** Improve early identification of model performance issues through granular monitoring and validation. Perform frequent, detailed back-testing across more models and segments and extend monitoring to key ECL components. **Model Segmentation:** Refine model segmentation to better capture sector-specific risks. Reassess alignment with high-risk segments and use data to monitor these segments closely to inform PMAs.
2 **Default Experience and Loss Given Default (LGD) Models**	**Challenge Recovery Assumptions:** Ensure recovery assumptions for LGD are realistic, especially with new or complex recovery strategies such as forward flow debt sales and delayed mortgage possessions, to avoid potential biases and unaccounted risks in LGD calculations. Use tools to monitor portfolio impacts and challenge biases in uncertain recovery outcomes. **Monitor Recovery Strategies:** Closely monitor forward-looking recovery assumptions to detect changes early and incorporate them into ECL calculations. Enhancing reporting for better insights into segments sensitive to recovery strategy changes.	**Challenge Recovery Strategy Failure:** Enhance methods to capture the likelihood and impact of recovery strategy failure in LGD assessments. Challenge model assumptions and use management information to assess impacts on vulnerable sectors. **Granular Monitoring of LGD Models:** Increase granularity in monitoring LGD models to compare performance against actual recovery experience. Monitor key components such as time to recover and collateral haircuts and conduct segment-level analysis for portfolio changes.

Thematic Findings on IFRS 9 ECL (2/3)

Areas of Focus	Near Term Focus	Medium Term Focus
3 **Affordability and Refinance Risks**	**Frameworks for Identifying At-Risk Populations:** Expand frameworks to identify at-risk mortgage and lower credit quality corporate borrowers. Use long-term refinance risk assessments over three years, not just 12 months. **Long-Term Refinance Risk Assessments:** Use reasonable and supportable information for long-term refinance risk, such as the next three years. Monitor borrowers who refinanced in the last 18 months to ensure higher payments are sustainable.	**Enhanced Monitoring and Governance:** Develop and implement more granular approaches to monitor and manage longer-term refinance risk, particularly for fixed-term loans. This involves creating robust governance frameworks and analytical tools to assess how businesses and households adjust to higher debt payments over time. **Forward-Looking Assessments:** Incorporate forward-looking information into models to better predict future risks. This includes considering potential changes in economic conditions and their impact on borrowers' ability to refinance.
4 **Vulnerable Sectors and High-Risk Retail Borrowers**	**Portfolio-Level Trend Analysis:** Identify vulnerable borrowers to inform PMAs such as reviewing the trends of cash deposits. Expand analysis to spot vulnerable sectors and high-risk retail segments. **Horizon Scanning:** Conduct formal horizon scanning to ensure key risks are captured in ECL and challenge PMAs' completeness. Perform timely, granular sector-level analysis to ensure ECL covers key risks for vulnerable sectors and high-risk segments.	**Granular Analysis of Sectoral Risks:** Use granular analysis to support model segmentation and inform PMAs. Expand portfolio-level trend analysis to identify vulnerable sectors and high-risk segments. Conduct formal horizon scanning to ensure key risks are captured in ECL.

Thematic Findings on IFRS 9 ECL (3/3)

Areas of Focus	Near Term Focus	Medium Term Focus
5 **Strategic Redevelopment and Model Segmentation**	**Strategic Plans and Oversight:** Regular oversight by senior and cross-functional committees is essential to enhance capabilities and reduce reliance on PMAs. Ensure plans cover all model limitations and include contingencies for remediation if new models fail validation. **Model Segmentation:** Reassess alignment with high-risk segments and sectors. Increased granularity helps capture sector-specific risks. Use available data to monitor high-risk segments closely to inform PMAs.	**Strategic Plans and Oversight:** Ensure plans cover all model limitations and include contingencies for remediation if new models fail validation. Regular oversight by senior and cross-functional committees is crucial to enhance capabilities and reduce reliance on PMAs. **Model Operating Boundaries:** Define and monitor boundaries to identify performance issues and inform PMAs. Use sensitivity analysis to assess model performance within margins and monitor economic scenarios to determine if PMAs are needed.

The effective management of IFRS 9 ECL practices is vital for ensuring the safety and soundness of banks and building societies. By addressing the thematic findings outlined in this paper, firms can enhance their risk management frameworks and better navigate the uncertainties posed by the current economic environment.

How we can assist you on this journey

Many firms have already developed their Next-Gen IFRS 9 models or are currently in the process of doing so. Beyond the areas highlighted by the PRA, we continue to encounter additional challenges, such as the use of COVID-period data and the insensitivity of macroeconomic data.

We are actively supporting firms in addressing these issues, providing us with real-time insights into the key challenges they face in the evolving landscape of IFRS 9 models.

With our deep understanding of regulatory and auditor expectations, we can help future-proof your models and processes related to IFRS 9 and broader risk management.

Capital and Impairment Risk Advisory – IFRS 9

We provide comprehensive support in designing and developing ECL models, conducting independent model validation, and establishing robust governance frameworks. Our services ensure compliance with IFRS 9 standards, facilitating accurate financial reporting and effective risk management.

Our key services:

- **Model Development:** Design and develop ECL models tailored to client portfolios.
- **Model Validation:** Conduct independent validation of IFRS 9 models to ensure compliance and accuracy.
- **Ongoing Model Monitoring:** Implement processes for continuous monitoring of model performance.
- **Governance Frameworks:** Establish robust governance frameworks, including policies and procedures for model management and reporting.
- **Reporting:** Support in preparing and submitting MI and financial statements related to IFRS 9.
- **Audit Support:** Provide support during internal and external audits.

Find out more

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